STATEMENT

by

Mid Willamette Valley Council of Governments

on

The Small Business Administration

504 Loan Guaranty Program

Expanding Small Business Access to Capital

Submitted to the

SUBCOMMITTEE ON FINANCE & TAXATION

COMMITTEE ON SMALL BUSINESS

UNITED STATES

HOUSE OF REPRESENTATIVES

by

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Mid Willamette Valley Council of Government is pleased to provide a statement to the House of Representatives Subcommittee on Finance and Taxation about our proposals to improve access to capital by small businesses.

The Mid-Willamette Valley Council of Governments is a voluntary association of local governments in Marion, Polk and Yamhill Counties that provides a number of key development services to cities and counties – such as land use planning, regional economic development planning, public infrastructure development assistance, as well as a variety of small business finance programs to business regionally and statewide.

The COG is organized as a public agency and is governed by a board of 19 local elected officials. Many of the programs of the COG are overseen by various policy boards often made up of both elected officials and business leaders.

In 1983, and in cooperative effort between MWV COG and two neighboring Councils of Governments, Cascades West Financial Services, Inc. (Certified Development Company) was founded to provide the US Small Business Administration's 503/504 loan programs. Currently Cascades West is the largest Oregon based CDC with a portfolio of $77.7 million and 186 SBA 504 loans.

Cascades West Financial Services is a member of NADCO, a membership organization representing the Certified Development Companies (CDCs) responsible for the delivery of the SBA 504 program. NADCO has 260 CDCs and more than 200 affiliate members, who provided more than 98% of all SBA 504 financing to small businesses during 2008. NADCO is Cascades West Financial Services link with SBA and Congress to work on issues and concerns with the SBA programs. Cascade West Financial Services and the other CDCs share a mission of community and economic development achieved through the delivery of the SBA 504 and other economic development programs and services that are customized to the needs of their respective communities.

CDCs work closely with SBA and their lending partners (generally banks and federal credit unions) to deliver what is certainly the largest and most successful federal economic development finance program in history (over two million jobs, $44 billion in authorized 504 loans and the leveraging of over $50 billion in private investment since 1986).

We would like to thank Chairman Schrader and the entire Sub-committee, for continued support of small business in America and the 504 program.

We believe our proposed changes will improve the 504 program in order to increase access to long term capital by small businesses, during and following this recession.

Reduce 504 Program Costs for Small Businesses:

SBA informed us that its 2010 budget <u>increases the cost of the 504 program by 38.9 basis points per annum</u>. This is due to at least two factors in the SBA's "econometric" subsidy model: the national unemployment rate and the forecast of the 504 default rate.

These factors are impacted by the current recession, their real effect is expected to be short-lived, so we ask the Committee to consider requesting an appropriation sufficient to offset this fee increase for the next two years as small businesses return to a growth mode and improve their cash flow to pay increased program fees. We request this be taken up as soon as possible in order to negate the impact of this subsidy fee increase on our borrowers for FY 2010. It does not seem right in this economy to give small businesses fee relief from the Stimulus Bill in February 2009 and turn around and increase their cost of borrowing in October 2009.

Background:
Since FY 1997, the 504 program has been at zero subsidy; that is to say, fees paid by small business borrowers, CDCs and first mortgage lenders have covered the entire cost of the program. Until passage of the stimulus bill in February of this year, no taxpayer funds have been appropriated for the program in over ten years. While our CDC industry association requested a more detailed discussion with SBA's subsidy experts, an analysis of the OMB Federal Credit Supplement reveals that SBA is projecting that loan defaults for 504 will increase from 3.5% for FY 09 to over 7.3% for FY 2010. Together with the unemployment rate increase, these two factors may well account for the majority of the fee increases over the next two years.

We are concerned about this forecast of the program default rate. Surveys of our CDC industry association membership and information on bank credit underwriting lead us to a very different conclusion than the SBA has drawn for this critical factor. In fact, both bank's AND SBA's own underwriting of 504 loans have become far more conservative during this recession. The "credit box" has become much tighter, and only the strongest small businesses are now qualifying for new loans. Further, with most businesses more carefully husbanding their cash, demand for fixed plant expansion is coming from only the stronger small businesses. Finally, appraisers have become much more conservative in their valuations of commercial real estate, making expansion capital of any kind much more difficult to obtain.

Combining all these factors, it is clear that the FY10 loans we make to small businesses may be among the best and most conservatively underwritten in the twenty-two year history of 504 lending. Our industry association strongly believes that loan defaults for the 2010 loans will substantially <u>decline</u>, not go up, as now forecasted by SBA's subsidy modelers.

If nothing is done by Congress, the result will be identical to what occurred in FY 1997 when OMB grossly overestimated the defaults and cost thousands of small businesses millions in inflated guarantee fees. In FY 2010 we will see borrowers paying unnecessarily high program fees at the worst time: when they need access to affordable 504 loan capital so they can preserve their cash for working capital to undertake their company expansion and create jobs. With inflated guarantee fees for both FY 2010 and 2011, almost 20,000 small businesses will pay millions in extra fees to SBA over the entire twenty years of their 504 loans. The 504 program will become less and less effective for small businesses creating new jobs.

The only way to restore the fairness of this subsidy process is for Congress to step in and appropriate sufficient federal funds to offset these fees. We request this be taken up as soon as possible in order to negate the impact of this subsidy fee on our borrowers for FY 2010.

Reach Out to More Small Businesses With New Capital:

The Congress and the Obama administration have worked hard to put more fixed asset and working capital in the hands of small businesses hard pressed by this recession. Our thanks to both for taking a leadership role by adding key programs to the stimulus bill earlier this year that are beginning to impact capital access and job creation.

The 504 program loan eligibility and underwriting policies set forth by SBA that are so critical to maximize the effectiveness of these programs were drifting towards more conservative interpretations on numerous issues. We support a number of recommendations to truly expand the availability of 504 funding to more small businesses. These include:

<u>Increase the maximum 504 loan size</u>: We request that the limit for a regular 504 loan be increased from \$1.5 million to at least \$3.0 million, and the limit for critical public policy loans go from \$2.0 million to at least \$4.0 million. Commercial real estate construction costs have increased substantially in the last five years, and the program benefit must keep up with these costs for small businesses.

<u>Allow use of home equity lines of credit for owner 504 equity access</u>: SBA had moved to restrict 504 borrowers from using proceeds of their home equity lines of credit for their cash injections into their 504 projects, a practice used for over twenty years with no documented increase in credit risk. While this new SOP change has been temporarily placed in abeyance, we are seeking a more permanent solution to this issue. We request that this option for use of borrower's home equity lines be continued through legislated guidance to SBA. In our experience most growing earlier stage businesses use home equity lines of credit for a source of business working capital, down payments on equipment and any and all other business uses. In a very real sense business owners are "all-in" with sources of financing. SBA restricting use of a home equity loan does not fit the reality of the entrepreneur.

<u>Assist businesses in low income areas</u>: We request that the benefits of the public policy loan limits be made available to small businesses located in low income areas, to include those that would be eligible for new markets tax credits. Many traditional lenders have moved away from making loans in these areas due to perceived added risk. More capital must flow to these small businesses that create jobs in areas of low income and extremely high unemployment. This is a core mission of the 504 program.

<u>Combine the benefits of certain public policy goals</u>: Small businesses owned jointly by minorities, women, or veterans (all now individually public policy qualified) should be able to qualify for a "combined" benefit if they own at least 50% of the business, rather than the current regulatory restriction of 51%. This will enable many more small firms to obtain added capital.

<u>Maximize both 504 and 7(a) loan eligibility for a borrower</u>: Small businesses typically need added working capital when building a new larger 504 project, yet this is frequently restricted under current SBA regulations. Particularly in this credit crisis, we must make this capital available for inventories, salaries and business operating expenses, in ADDITION to the funds for the building construction.

<u>Uniform leasing policy</u>: Small businesses should be able to lease out 50% of their space, whether it is newly constructed or an existing building, for both the 504 and 7(a) programs, and this will actually reduce credit risk while providing added potential expansion space for these growing firms well into the future. This change is especially important in rural communities where a doctor or a dentist may not be able at first to use the entire space.

<u>Acquisition of stock</u>: Some small businesses being acquired by new owners should be allowed to make the fixed asset transfer through a stock sale, so long as the assets are 504 eligible. Our experience is that this change allows a business acquisition be constructively structured—fix assets financed with

long term debt and reasonable payment schedule, rather than a "patch-work" of conventional short term financing with large payments. Frame this 504 program change to a real situation we had two years ago with a management teams' purchase of a family business—the competing buyer would sell the current contracts in place, move the equipment to China, while laying off 30 to 50 employees in a small rural town; the SBA 504 application was denied as ineligible because the purchase agreement transferred the company stock to the buyers when they purchased the fixed assets. SBA deemed the transaction was a purchase of stock, not a fixed asset purchase. So the local back went ahead with a variety of short term loans and risky schedule of repayments—today the business is a weaker working capital position and a slow economy.

<u>Definition of "rural" areas</u>: SBA continues to apply outdated population parameters to rural areas, which restricts 504 from assisting rural borrowers through public policy loans. We request that the more current USDA definitions of "rural" areas be applied to SBA programs to increase the availability of capital in these areas.

<u>Allow Refinancing of Conventional Bank Loans</u>: Allow the 504 program to be available to refinance existing conventional bank loans, especially loans with 5 year call provisions, in the process freeing equity and working capital.

This last suggested change comes from concerns that as the banks for these companies fail or substantially tighten their lending standards; performing loans to good companies are being called, forcing historically good small businesses with performing loans into foreclosure and causing jobs to be lost. These companies chose this type conventional financing when commercial mortgage backed securities industry was active, now the capital markets are frozen and banks are restricting lending. Refinancing with the SBA 504 loan structure is a sustainable alternative—the company gets a fixed rate, lower than market rate of interest, over 10 or 20 years and the bank has a loan structured for the commercial mortgage backed securities industry when these capital markets recover. We support this win-win for businesses and banks. Now we need a "time is of the essence" SBA regulatory change.

<u>Control and Reduce Loan Losses for the 504 Program:</u>

Loan defaults and losses have increased for 504, as for all other commercial lending – both public and private – during this recession. It is imperative for changes to be made to control these losses in the future. We make the following recommendations to address this goal:

<u>CDC responsibilities for loan liquidation and recovery</u>: SBA's limited liquidation staff is being overwhelmed with loan defaults, which is leading to higher loss rates for 504. In turn, this will result in higher subsidy costs and fees for future borrowers. We urge Congress to enable qualified CDCs to perform liquidation and recovery work, and require that SBA simply compensate CDCs for staff liquidation work from the certain increased recovery amounts, as their own regulations require (which have not been funded by the Administration).

<u>Additional equity injections</u>: To reduce debt service costs, some borrowers would like to have smaller private bank first mortgages (always at a higher cost to the borrowers than the federal government's second position) and larger 504 second mortgages. We request that the requirements for bank participants be more flexible to reduce overall project debt costs, which will enable borrowers to save cash for working capital, and almost certainly result in lower delinquencies and loan defaults.

Collection and accounting for defaulted 504 loans: We request that accounting for defaulted 504 loans, as well as new secondary work-out loans with borrowers, be continued at the program's efficient and highly automated Central Servicing Agent. This will result in timely, accurate loan accounting and portfolio servicing, and enable CDCs to service these notes more rapidly and effectively. This will both reduce costs for SBA and increase overall recoveries from 504 defaults.

Make SBA Programs More Relevant and Productive:

Loan volume for both the 504 and 7(a) guarantee programs has improved since passage of the stimulus act, but many of those benefits are just now being implemented by the SBA. However, in spite of the stimulus bill, both programs are still down as much as 40% from their highest levels two years ago.

A substantial part of this volume loss is clearly due to this historic recession with small businesses pulling back on demand for long term capital. But part may also be due to SBA, and even our own lending industries, failing to fully respond in innovative new ways to the ever-changing needs of small business financing. As we have seen with our inability to convert equity to working capital, and the ever more conservative policies on loan programs, it is possible that SBA's programs are becoming less relevant as small businesses are pushed to find other, and often more expensive, means of funding their growth and job creation.

Each of these guarantee programs is over twenty years old, and an environment of restrictive and potentially unnecessary regulations has evolved within the Federal bureaucracy. With this new administration, and the fresh thinking from senior policymakers it is attracting, this is an opportunity to break out of some of the old program's structure and bureaucracy. We see the chance to work with this new leadership team, and with the new Congress to expand the reach of the many benefits of both 504 and 7(a) to more borrowers with different capital needs in new and leading edge industries that will be the job creators for the next fifty years.

In order to begin a "re-thinking" of the program, its ability to serve small business, and an expansion of its benefits, we believe that there must finally be established the organizational parameters and control guidelines for Certified Development Companies that deliver the 504 program to the nation. The very definitions of our industry and its financing services should not be left to the sometimes arbitrary evolution of regulations that are designed to control the "lowest common denominator" of the program.

Our CDC industry association carefully evaluated the existing industry structure and concluded that there is a need for codification of key facets of the industry and key program components. We request consideration of the following recommendations to firmly establish guidelines for our industry:

Certified Development Company structure: Low cost program delivery is at the core of 504's benefits for small business borrowers. As SBA and our industry seek to grow the delivery organizations for 504, the program should continue to be delivered by not-for-profit, community-based organizations that are focused on economic development in their local areas. We strongly support NADCO's series of recommendations that address this goal, and through codification, make it an absolute requirement for all new CDCs. Some of these recommendations mirror beneficial SBA rules, while others are completely new requirements that will maintain the advantages of today's low cost delivery of 504.

For over 20 years the staffs of our COG, Lane and Cascades West COG's provided CDC management, 504 loan marketing, loan underwriting, loan closing and loan servicing with a low cost, collaborative, and unique delivery model. SBA changed the CDC operations regulations, dictated one type of operational structure for all, disregarding CDC's collaborative community based operating model. The resulting costs to our CDC were unnecessarily borne, potentially crippling and are ongoing until SBA regulatory changes are made. We are not alone as there are other similar community based models also impacted by these regulations. The proposed changes in the SBA reauthorization bill to allow our CDC to go back to our successful operating model. We cannot emphasis how important this one change is to our low cost delivery of economic development lending to small business borrowers.

CDC management and ethical structure: With the recent corporate "implosions" in the financial services industries that led to many of the reasons for this credit crisis, we support NADCO that there must be codified requirements for the ethical and service standards of the CDC industry. CDCs have a long history of focus on community benefits, rather than the profit goals of traditional private lenders. In order to maintain this focus, we urge that our recommendations be implemented to maintain these standards for the benefit of our future borrowers.

Multi-state service by CDCs: Some of the current industry structure has evolved on a haphazard basis without careful consideration of small business needs in individual communities. "One size" does not fit all communities, and the expansion of CDC services must be carefully structured. Our industry association makes a series of recommendations to enable Congress to provide definitive guidance for the future. For example Oregon has 5 Oregon community based CDCs; and now 3 large out of state CDCs that are not community based. At the very least, the recommended changes state the money made in the state by the large out-state-CDCs must be used in the state for economic development, which does not happen currently.

504 Debenture definition and clarification: The key component of the 504 program benefits is access to the capital markets for long term loan funding. Our low cost of debt is derived from the program's long term consistency of its funding security structure. Our security's portfolio performance has led to investment attractiveness by a very broad segment of major corporate investors and financial institutions, based both in the U. S. and overseas. This belief in our consistent performance and portfolio structure has directly led to lower interest rates for many years. For example, in spite of this credit crisis, our July 2009 interest rate for our borrowers was the second lowest in the twenty-three year history of 504. So even as Fortune 500 corporations are having trouble finding funds at ANY cost, the 504 program continues to function as the "window to Wall Street" for thousands of small businesses; providing funds on long terms and at the lowest possible cost.

The consistency of the funding security, known as the Development Company Participation Certificate, must be maintained in the future, regardless of the political changes that occur from administration changes. Modification of our security's terms will result in increased interest costs for our borrowers. We support NADCO's request that Congress maintain the stability of our funding mechanism by codifying the payment schedules of principle and interest for our securities. This will remove the potential uncertainty of the borrower's payment streams, maintain the low interest rates, and insure long term access to the credit markets.

CONCLUSIONS:

For many years, 504 has been an extremely cost effective capital access program for thousands of growing small businesses that are the core job creators of the American economy. The program was in such demand that for several years its growth rate exceeded 20% each year. As the country slid into recession, many small business owners decided they could not take a risk of continued growth of their firms, so they stopped borrowing all but the necessary working capital to maintain their existing operations.

It is anticipated that “the dam is about to break”. That is to say, many small businesses are concluding that an economic turnaround is beginning to happen. You can see it in the growth of the investment markets. We can see it in the calls we get about the loan program. Our “pipeline” of loan projects is beginning to come back.

The 504 program is over twenty-two years old, in its basic form. But the need for long term capital has not changed in those years, and 504 remains as relevant and important as the day it came out. We are not proposing a radical change of direction for 504, but an incremental update and upgrade of a very successful capital access program that for over ten years has cost the taxpayer nothing.

The proposed changes make 504 an improved source of capital at just the right time for our economy, as small businesses begin to ask for long term fixed asset and plant expansion funding. With these changes, and rapid implementation by SBA, 504 will be just the right program at just the critical time for small businesses. We ask Congress to pass these recommendations, and work with SBA and our industry association (NADCO) to help restore the American dream of business ownership and entrepreneurship.

Thank you for your support.